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AEI-BROOKINGS JOINT CENTER FOR REGULATORY STUDIES

## **An Analysis of the Tenth Government Report On the Costs and Benefits of Federal Regulations**

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## Executive Summary

This paper critically reviews the draft of the Office of Management and Budget's tenth report on the benefits and costs of federal regulations. The draft report is similar to previous reports, and does not break new ground.

This paper critically reviews the draft of the Office of Management and Budget's tenth report on the benefits and costs of federal regulations. The draft report is similar to previous reports, and does not break new ground.

We offer seven recommendations—six for OMB and one for Congress—that would help hold lawmakers and regulators more accountable for the regulations they produce. Our recommendations focus on getting the regulatory agencies to produce better analysis, making that analysis more transparent and readily available, and making the regulatory process itself more transparent.

We recommend that OMB:

- examine the extent to which regulations maximize net benefits;
- include a scorecard showing the number and percentage of final regulations that pass a benefit-cost test based on factors that can be quantified and monetized;
- request that all agencies report on the extent to which they comply with OMB's guidelines for conducting regulatory analysis using a regulatory scorecard for individual RIAs;
- provide guidelines for assessing the effectiveness of antiterrorism regulations;
- include a discussion of the costs and benefits of antitrust activities in its annual report; and
- facilitate the use of information markets for public and private purposes by issuing a prompt letter to the Commodity Futures Trading Commission and encouraging Congress to lowering regulatory barriers to starting these markets.

We also recommend that Congress require *all* agencies to comply with OMB's guidelines for conducting regulatory analysis.



## **An Analysis of the Tenth Government Report On the Costs and Benefits of Federal Regulations**

Robert W. Hahn and Robert E. Litan

### **1. Introduction**

The Office of Management and Budget (OMB) has recently released a draft of its tenth annual report to Congress on the costs and benefits of federal regulations.<sup>1</sup> The law requires that OMB submit a report to Congress that provides estimates of the costs and benefits of federal regulations. The report is also supposed to make recommendations for reform, provide guidelines for agencies to standardize benefit and cost estimates, and assess the impact of federal regulation on State and local government, small business, wages and economic growth.<sup>2</sup>

The 2007 OMB draft report offers an expanded discussion of major rules issued by independent regulatory agencies.<sup>3</sup> OMB uses an abbreviated scorecard to note the percentage of independent agency rules that include some information on costs or benefits. OMB frequently reiterates the difficulty in evaluating independent agency rules since it does not analyze these rules and seeks comment on how to develop the discussion. While the discussion is limited, we applaud OMB's efforts to summarize available information on the independent agencies.

In this analysis, we argue that OMB has failed to address the most serious problems with agencies' regulatory analyses. We offer seven recommendations—six for OMB and one for Congress—that would help address these core issues.

We recommend that OMB: examine the extent to which regulations maximize net benefits; include a scorecard showing the number and percentage of final regulations that pass a benefit-cost test; request that all agencies report on the extent to which they comply with OMB's guidelines for conducting regulatory analysis; provide guidelines for assessing the effectiveness of antiterrorism

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<sup>1</sup> OMB (2007).

<sup>2</sup> The FY2001 Treasury and General Government Appropriations Act, § 624 (a) requires OMB to submit an “accounting statement and associated report” containing: “(1) an estimate of the total annual costs and benefits (including quantifiable and non-quantifiable effects) of Federal rules and paperwork, to the extent feasible: (A) in the aggregate; (B) by agency and agency program; and (C) by major rule; (2) an analysis of impacts of Federal regulation on State, local, and tribal government, small business, wages, and economic growth; and (3) recommendations for reform.” Section 624 (c) also requires OMB to “issue guidelines to agencies to standardize: (1) measures of costs and benefits; and (2) the format of accounting statements.”

<sup>3</sup> The draft report also includes a new chapter on agency compliance with the Unfunded Mandates Reform Act (UMRA). The annual report on agency compliance with the UMRA is usually included with the final report on the costs and benefits of federal regulations. This is the first time it is included in the draft. We do not review this section here.

regulations; include a discussion of the costs and benefits of antitrust activities in its annual report; and facilitate the use of information markets for public and private purposes by issuing a prompt letter to the Commodity Futures Trading Commission aimed at lowering regulatory barriers to starting these markets.

Requiring agencies to comply with OMB's guidelines has been unsuccessful. The guidelines have little value if they are not seriously enforced. We recommend that Congress require *all* agencies to comply with OMB's guidelines for conducting regulatory analysis.<sup>4</sup>

Section 2 offers recommendations for improving OMB's report and regulatory oversight function. Section 3 presents our conclusions.

## **2. Recommendations**

While OMB has addressed a few key issues in this report, there is significant room for improvement. We offer seven recommendations aimed at improving the OMB report and the regulatory process.

### **Recommendation 1: OMB should add a discussion in its report that assesses the extent to which the regulations under consideration maximize net benefits.**

To assess the extent to which the regulations maximize net benefits, the agencies should identify the alternative or alternatives that maximize expected net benefits. They should then quantify those net benefits to the extent reasonable. In addition, they should also explain why those alternatives are not selected in cases where they are not selected.

Specifically, we believe that it is important to identify efficient alternatives even when they are not legally permissible. Executive order 12291 requires this, while executive order 12866 does not preclude it.<sup>5</sup> Agencies should also make an argument for why they expect benefits to exceed costs (even qualitatively). This could be especially important when many key benefits or costs cannot be monetized.

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<sup>4</sup> All agencies include both executive and independent agencies.

<sup>5</sup> According to Reagan (1981), §3(d)4, each Regulatory Impact Analysis shall contain the following information: "A description of alternative approaches that could substantially achieve the same regulatory goal at lower cost, together with an analysis of this potential benefit and costs and a brief explanation of the legal reasons why such alternatives, if proposed, could not be adopted." See also Clinton (1993).

In general, however, we think it would be useful to present net benefits as a best estimate of the best estimate of costs minus the best estimate of benefits. This calculation forces movement in the direction of quantifying other benefits, though the caveats of key missing costs or benefits should be noted. Otherwise, there will always be a tendency to hide behind the lack of full information on costs or benefits. We are not implying that the net benefit calculation will always be very useful by itself, but it will create an incentive to get better information. In the meantime, the agency can point out that the estimate should not be used on its own.

See last year's analysis for details, published by the AEI-Brookings Joint Center and available at <http://www.aei-brookings.org/admin/authorpdfs/page.php?id=1290>.

**Recommendation 2: OMB should include a scorecard showing the number and percentage of final regulations that pass or fail a benefit-cost test based strictly on factors that can be quantified and expressed in monetary terms.<sup>6</sup>**

Discussion: See last year's report published by the AEI-Brookings Joint Center.

**Recommendation 3: OMB should request that *all* agencies report on the extent to which they comply with OMB's guidelines for conducting regulatory analysis using a regulatory scorecard.**

OMB could start by asking each agency to fill out a standardized scorecard for each Regulatory Impact Analysis (RIA). One scorecard has been proposed by Hahn and Sunstein (2002).<sup>7</sup> OMB could then ask agencies to aggregate the information from those individual scorecards. OMB should assemble this information and present it in a user-friendly format.

Summary information on individual RIAs is potentially useful for individuals interested in a particular regulation. Aggregate information is potentially useful for determining if there are systematic strengths and weaknesses in how RIAs are done in each agency.<sup>8</sup>

In the past, we have recommended that OMB issue a scorecard identifying the extent to which regulatory analyses comply with its guidelines for conducting regulatory analysis. OMB, however, has

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<sup>6</sup> This scorecard should include all final, economically significant regulations summarized in the aggregate. The time frame should be at least the past decade.

<sup>7</sup> See Table 4, Hahn and Sunstein (2002, 1519).

<sup>8</sup> See Hahn and Dudley (2007).

not yet implemented this recommendation. Interestingly, this year, OMB did issue a summary report of major rules issued by independent agencies, an effort we applaud.<sup>9</sup>

**Recommendation 4:** Congress should require that all agencies comply with OMB's guidelines for conducting regulatory analysis.

Discussion: See last year's report published by the AEI-Brookings Joint Center.

**Recommendation 5:** OMB should provide guidelines for how the Department of Homeland Security should quantify and monetize the benefits of antiterrorism regulations.

Discussion: See last year's report published by the AEI-Brookings Joint Center.

**Recommendation 6:** OMB should include a discussion of the costs and benefits of antitrust activities in its annual report.

Discussion: See last year's report published by the AEI-Brookings Joint Center.

**Recommendation 7:** OMB should facilitate the use of information markets for public and private purposes by issuing a prompt letter to the Commodity Futures Trading Commission aimed at lowering regulatory barriers to starting these markets. OMB should also consider alerting Congress to the role it could play in stimulating the development of prediction markets by reducing barriers to entry.

A fundamental problem with benefit-cost analysis in assessing new regulations is that it is usually done before the fact. It is *ex ante* as opposed to *ex post*. When doing analyses before the fact, it is difficult to predict the future values of key variables that could be affected by a policy. The analyst may need to forecast, for example, the net benefits of a regulation to reduce arsenic several years before any benefits are realized. We think that information markets could be used to estimate parameters that

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<sup>9</sup> See OMB (2007), at 16.



would be directly useful for doing a benefit-cost analysis.<sup>10</sup> Information markets are markets for contracts that yield payments based on the outcome of an uncertain future event, such as the impact of an EPA air quality regulation on the incidence of lung cancer twenty years from now. An information market allows individuals to purchase contracts, using real money, that yield payments to their owners that depend on the uncertain outcome of a future event.<sup>11</sup> With the advent of the Internet, information markets are becoming more widespread. They are used in a number of contexts ranging from assessing the likelihood that the Federal Reserve will raise interest rates to assessing the odds that a particular presidential candidate will be elected.

But how confident should we be in the results derived from information markets? We can be more confident in such results if we introduce information markets that allow people to profit from superior knowledge about the future.<sup>12</sup>

If there were an information market that suggested that the incidence of cancer would decrease by 10% with a particulate matter regulation, this estimate would in theory incorporate all publicly available information about that regulation's effects.<sup>13</sup> Moreover, information from the prices in these markets is likely to dominate other forecasts if the information markets are designed well.

OMB should consider encouraging regulatory agencies to facilitate the use of information markets that could provide information on the costs and benefits of regulation. It should also advise agencies on how to apply information markets to determine the economic impacts of regulations. At this point, the benefit-cost estimates derived from information markets should supplement, not replace, conventional regulatory analyses.

In order for OMB and the agencies to use information markets, they must be allowed to do so. There are, however, several regulatory hurdles to establishing such markets, largely arising from state prohibitions on Internet gambling. The authority for regulating many information markets should be shifted from the states to the federal government, and the federal government should implement a clear

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<sup>10</sup> We use the terms "information market" and "prediction market" interchangeably.

<sup>11</sup> For a useful definition of information markets, see Wolfers and Zitzewitz (2004), at 108. "Analytically, these are markets where participants trade in contracts whose payoff depends on unknown future events." The literature also refers to these markets as "speculative markets" and "betting markets." For a discussion of speculative markets, see Hanson (2003) (revised), at 6: "Most markets for stocks, bonds, currency, and commodities futures are called *speculative markets* because they allow people to bet on future prices by buying or selling today in the hope of later reversing such trades for a profit." For a discussion of "betting markets" see Rhode and Strumpf (2004).

<sup>12</sup> See, e.g., Hanson (2003) (revised). See also Abramowicz (2004).

<sup>13</sup> When we say the market may "know", "believe" or "suggest," we are referring to the knowledge and beliefs of speculators in the market, which will be reflected in the market price. In what follows, when we ascribe a view to the market, such as "the market expects," we use this as a shorthand.

policy that would make it relatively easy to research and organize information markets that would improve economic decisions.<sup>14</sup>

Specifically, we would suggest that OMB ask the CFTC to lower regulatory barriers that impede the development of information markets. In addition, OMB should consider alerting Congress to the role it could play in stimulating the development of prediction markets by reducing barriers to entry.<sup>15</sup>

#### **4. Conclusion**

This analysis critically reviews the draft of the Office of Management and Budget's tenth report on the benefits and costs of federal regulation. We offer seven recommendations—six for OMB and one for Congress—that would help hold regulators and lawmakers more accountable for the regulations they produce. Our recommendations focus on getting the regulatory agencies to produce better analysis, making that analysis more transparent and readily available, and making the regulatory process itself more transparent.

Finally, while we believe that covering new topics can have value, we believe OMB should focus on a few critical components of the report. The most important, in our view, is to obtain accurate assessments of the costs and benefits of major individual federal regulations and viable alternatives to those regulations. With such information, decision makers and interested parties will be in a better position to gauge the effectiveness of the federal regulatory process. Once OMB begins to develop more accurate assessments of the costs and benefits of individual regulations, it may want to consider exploring possible reforms that Congress may want to enact.<sup>16</sup>

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<sup>14</sup> For a more in-depth discussion of how to regulate information markets, see Hahn and Tetlock (2006).

<sup>15</sup> See Arrow et al. (2007) and Hahn and Tetlock (2007). This recommendation to Congress could be presented in the final report on the costs and benefits of federal regulations. The Regulatory Right-to-Know Act specifically calls for OMB to include “recommendations for reform.” See Section 624 of the Treasury and General Government Appropriations Act of 2001 (Pub. L. 106-554, Sec. 1(a)(3), 31 U.S.C. § 1105 note, (a)3).

<sup>16</sup> For example, OMB may want to weigh in on regulatory policies in specific sectors. Possibilities include the regulation of the Internet and the regulation of the electricity sector.

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